By Thomas Wash

The business cycle has a major impact on financial markets; equity bear markets usually accompany recessions. The intention of this report is to keep our readers apprised of the potential for a recession, updated on a monthly basis. Although it isn't the final word on our views about recession, it is part of our process in signaling the potential for a downturn.

September 25, 2025

The US economy continued to expand in August, though warning signs are starting to appear. Our proprietary *Confluence Diffusion Index* remained out of contraction territory for the seventh straight month. Three indicators slipped back into contraction, raising the total number of warning signals to five out of 11. Despite these concerns, both stock and bond markets were bolstered by optimism regarding a potential shift in monetary policy. Signals from the "real economy" remain mixed, with business spending holding up, while households and firms continue to express concerns about the impact of tariffs. The labor market showed a notable slowdown, with firms hiring fewer workers, indicating a weakening in labor demand.

Financial Markets

Investors broadened their focus beyond the Information Technology sector. This shift is supported by growing optimism about the wider economy, driven by strong corporate earnings. Leading the performance charge were the Health Care and Materials sectors. In the bond market, yields have begun to fall as recent economic data suggests the Federal Reserve will prioritize maximum employment over price stability. This change in sentiment is largely due to evidence that the hiring slowdown was more significant than initially estimated, while inflation, though still elevated, has remained roughly in line with expectations.

Goods Production & Sentiment

August's economic data presented a mixed picture. While new orders continued to show signs of strength, the housing market painted a different story. Housing starts fell last month, in an indication that homebuilders remain hesitant to begin new projects due to ongoing uncertainty in the market. At the consumer level, households expressed growing apprehension about the labor market and persistent concerns over rising prices. Conversely, the business outlook, while still subdued, showed signs of improvement as deliveries have picked up, driven by firms actively rebuilding their inventories.

Labor Market

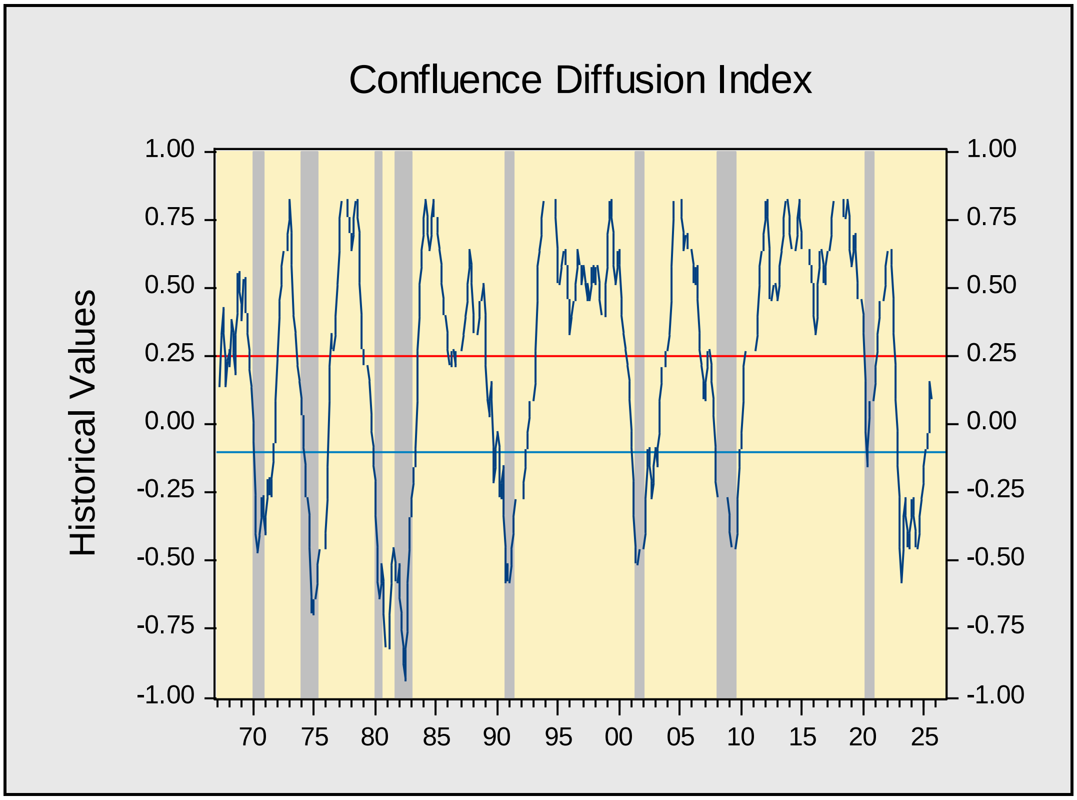
The US labor market showed further signs of deterioration in August, with hiring slowing to a critical level. For the first time since the pandemic, the number of payrolls has dipped into "contraction" territory, a clear signal that labor demand has weakened. While the unemployment rate remains low, it did tick up slightly from the previous month. Nevertheless, initial jobless claims have remained relatively subdued, suggesting that firms are still reluctant to lay off workers. The shift toward a "low-hiring, low-firing" labor market is a notable trend.

Outlook & Risks

The economy may have lost some of its momentum, but it remains in a good state. The possibility of easier monetary policy and continued investment in AI should provide a lift. We believe the markets will continue to focus on monetary policy and corporate earnings as investors seek reassurance that the economy is not being negatively impacted by tariffs. Consequently, we are cautiously optimistic about risk assets, given the strong underlying fundamentals, but we are waiting for confirmation that this growth is sustainable for the medium term.

The Confluence Diffusion Index for September, which provides a composite view of the economy based on 11 benchmarks, remains in expansionary territory according to August data. The index's value fell from +0.1515 in July to +0.0909 in August, but it is still well above the recovery signal threshold of −0.1000. This shows that while the economy continues to expand, the breadth of that expansion is narrowing. This is further evidenced by the fact that five of the 11 benchmarks are now in contraction, an increase from just two last month.

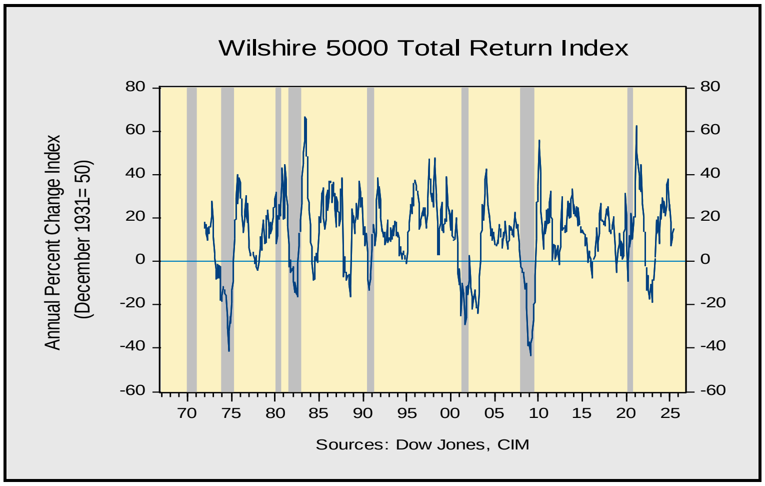
- Job growth concerns led to a flattening of the yield curve.
- Consumer sentiment is being weighed down by job uncertainty.
- The labor market appears to be in a phase of "low hiring and low firing."



The chart above shows the Confluence Diffusion Index. It uses a three-month moving average of 11 leading indicators to track the state of the business cycle. The red line signals when the business cycle is headed toward a contraction, while the blue line signals when the business cycle is in recovery. The diffusion index currently provides about six months of lead time for a contraction and five months of lead time for recovery. Continue reading for an in-depth understanding of how the indicators are performing. At the end of the report, the *Glossary of Charts* describes each chart and its measures. A chart title listed in red indicates that the index is signaling recession.

Financial Markets

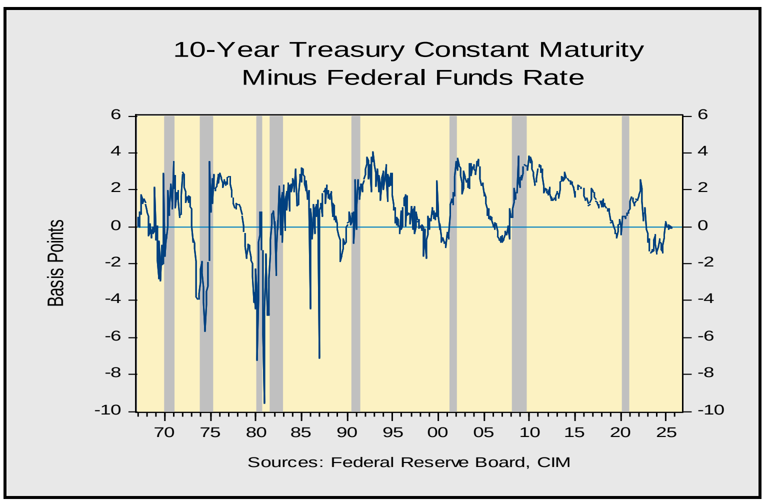
Wilshire 5000 Index



The Wilshire 5000 Total Return Index for August rose 15.7% from the prior year.

- Top-performing sectors: Health Care, Materials, and Consumer Discretionary.
- Bottom-performing sectors: Utilities, Information Technology, and Industrials.
- Indicates recession when the level falls below zero.

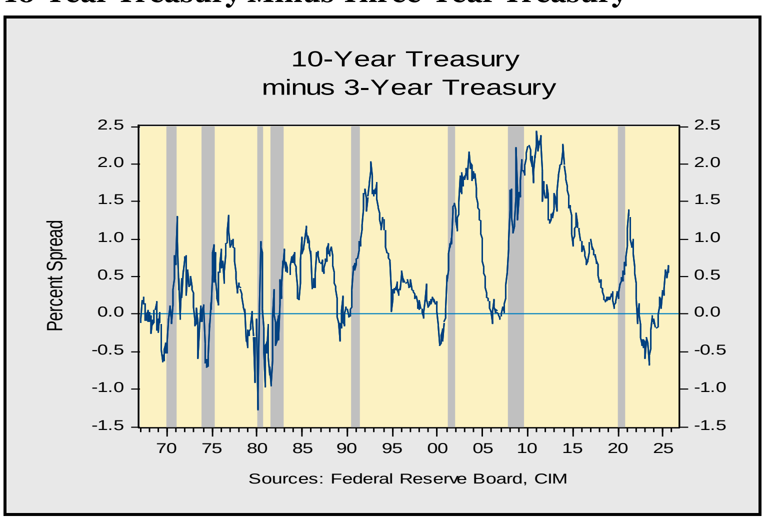
10-Year Treasury Constant Maturity Minus Federal Funds Rate



The financial spread, which is the 10-year Treasury yield minus the effective fed funds rate, dropped from +0.04 to -0.1.

- The effective fed funds rate was unchanged at 4.33%.
- The 10-year Treasury fell from 4.37% to 4.23%.
- Indicates recession when the level falls below zero.

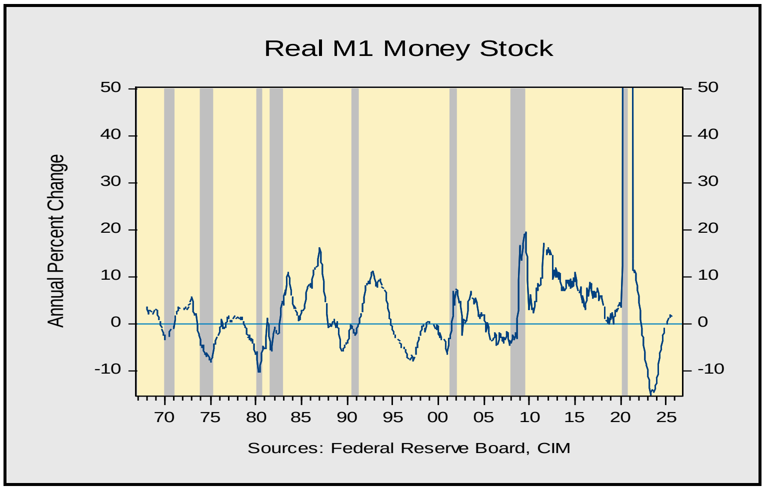
10-Year Treasury Minus Three-Year Treasury



The term spread between the 10-year and three-year increased from +0.48 to +0.65.

- The 10-year Treasury yield fell from 4.37% to 4.23%.
- The three-year Treasury yield decreased from 3.89% to 3.58%.
- Indicates recession when the level falls below zero.

Real M1 Money Stock

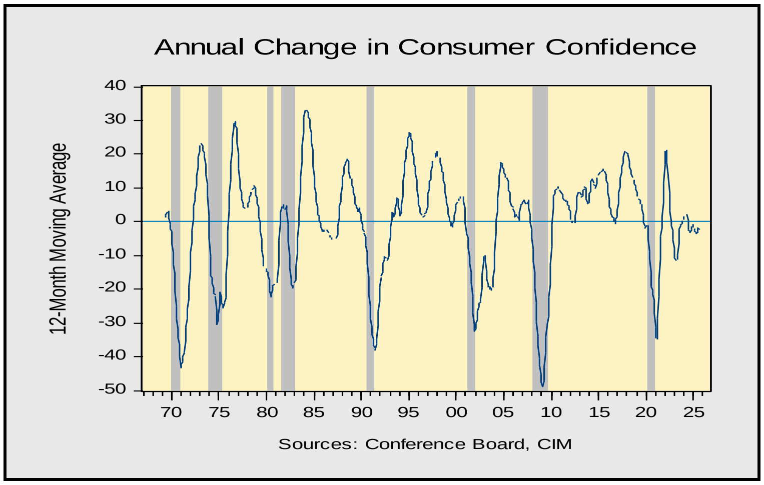


Real M1 money stock rose 1.6% from the prior year.

- Headline CPI rose 2.9% from the prior year.
- M1 money stock rose 4.5% from the prior year.
- Indicates recession when the level falls below zero.

Goods Production & Sentiment

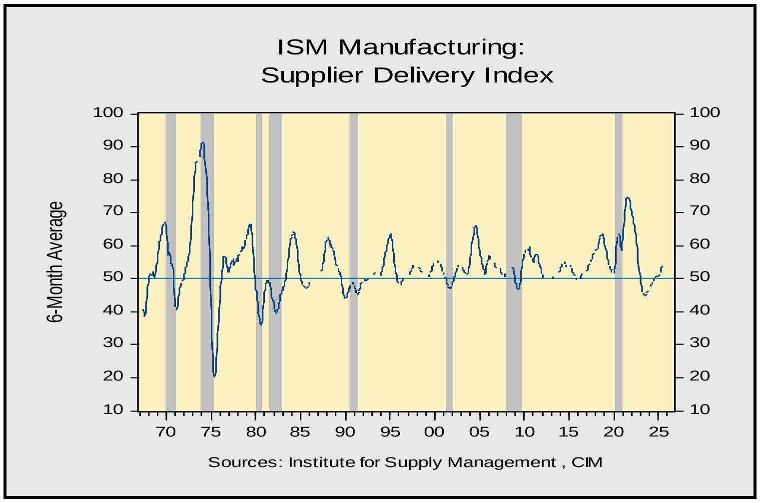
Consumer Confidence



In August, the 12-month moving average of the annual change in consumer confidence worsened from a revised -2.0 to -2.5.

- Consumer confidence came in at 97.4, down from 105.6 in August 2024.
- The sub-index for the current situation came in at 131.2, down from 134.6 last year.
- Meanwhile, the sub-index for future expectations decreased from 86.3 to 74.6 in the same period.
- Indicates recession when the level falls below zero.

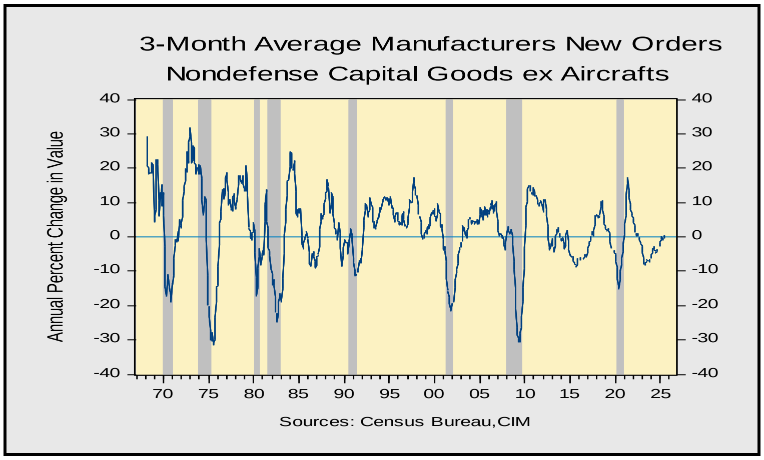
ISM Manufacturing: Supplier Delivery Index



The six-month moving average of the Supplier Delivery Index fell from 53.8 to 53.3.

- The overall index rose from 48.0 to 48.7.
- The Supplier Delivery Index increased from 49.3 to 51.3.
- Indicates recession when the level falls below 50.

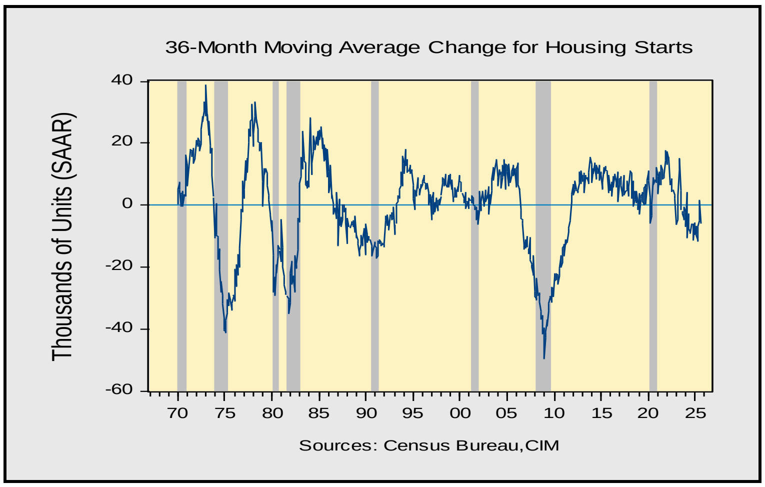
Three-Month Average Manufacturers' New Orders Nondefense Capital Goods excluding Aircraft



The three-month moving average of the annual change in new orders for nondefense capital goods rose 0.4% from the prior year.

- In August, new orders were relatively unchanged from the prior month but rose 0.6% from 2024 levels.
- Indicates recession when the level falls below zero.

36-Month Moving Average Change for Housing Starts

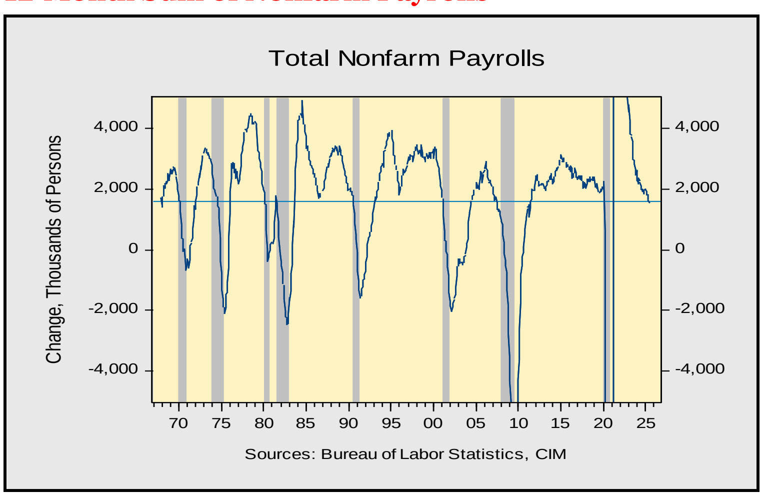


The 36-month moving average change for housing starts dropped from +1.31 to -6.22.

- Housing starts expanded at an annualized rate of 1,307k, below the previous month's revised pace of 1,429k.
- Single-family starts fell from 957k to 819k. Multi-family dwellings fell from 453k to 403k.
- Indicates recession when the level falls below zero.

Labor Market

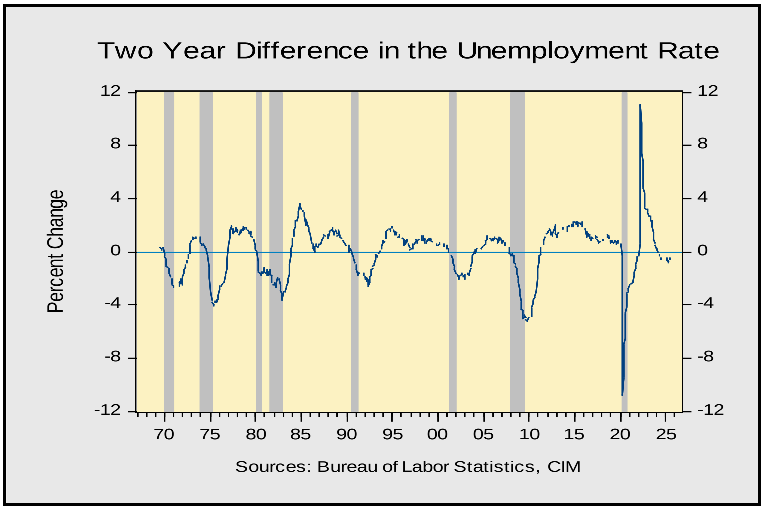
12-Month Sum of Nonfarm Payrolls



The 12-month moving sum decreased from a revised 1,515k to 1,466k.

- Nonfarm payrolls showed that the economy added 22k jobs in August.
- Service-Providing industries added 63k jobs. The Goods-Producing sector lost 25k jobs from the previous month, while the Government sector lost 15k jobs.
- Indicates recession when the level falls below 1,500k.

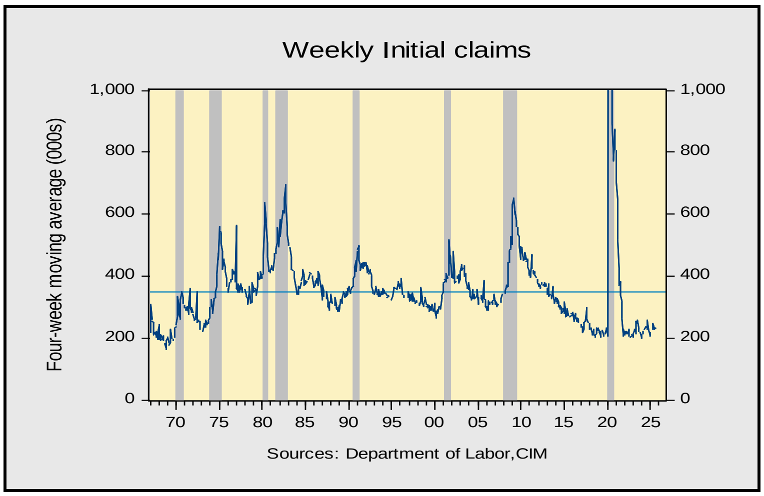
Two-Year Difference in the Unemployment Rate



The two-year difference in the unemployment rate improved from -0.7% to -0.6%.

- The unemployment rate rose from 4.2% to 4.3%.
- The number of unemployed rose 2.0% from the prior month.
- Indicates recession when the level falls below zero.

Weekly Initial Claims



Average weekly claims for August rose from 227k to 237k.

- Indicates recession when the level rises above 350k.

Thomas Wash, CBE
September 25, 2025

Glossary of Charts

Consumer Confidence: The Consumer Confidence Index is an economic indicator that measures the level of consumer optimism about the overall state of the economy and consumers' personal financial situations. This chart shows the 12-month moving average of the annual change of the index.

Wilshire 5000 Index: This chart shows the annual change in the Wilshire 5000 Total Return Index, which is the broadest US equity index. The index contains 3,500 stocks and is designed to track the overall performance of the US stock market. It is an important indicator because steep equity pullbacks have often coincided with economic contractions.

Three-Month Average Manufacturers New Orders Nondefense Capital Goods excluding Aircraft: This chart shows the annual change in the value of core capital goods orders. This indicator gives insight into the amount of business investment spending. A positive report suggests that manufacturers are optimistic about future demand.

10-Year Treasury Constant Maturity Minus Federal Funds Rate: This chart shows the spread between the 10-year maturity and the fed funds rate. It reflects the market sentiment of the future state of the economy. Generally speaking, a negative spread suggests a contraction is likely to occur within 24 months.

36-Month Moving Average Change for Housing Starts: This chart shows the 36-month moving average of the annual change in housing starts. This is an important indicator because it provides a gauge of future construction activity. If housing starts are strong, it implies that builders are optimistic about future demand.

ISM Manufacturing (Six-Month Average): The ISM Manufacturing Index is a report that monitors employment, production, inventories, new orders, and supplier deliveries. This index specifically focuses on the six-month moving average of supplier deliveries section in ISM, which we believe is a good gauge of future levels of manufacturing activity. A reading above 50 signals that manufacturing activity is expected to expand, while a reading below 50 signals that manufacturing activity is expected to contract.

Total Nonfarm Payrolls: This chart shows the 12-month moving sum of total nonfarm payrolls. This report represents the total number of workers added to the workforce, excluding proprietors, private household employees, unpaid volunteers, farm employees and incorporated self-employed. It is a significant indicator of the strength of the labor market. A moving sum that exceeds 1,600 suggests the demand for labor is intense.

Real M1 Money Stock: The Real M1 Money Stock report measures the annual change in the money supply minus inflation. M1 is the measure of currency in circulation and represents the amount of money being held for transaction purposes, therefore it can act as a proxy for economic activity.

10-Year Treasury Minus Three-Year Treasury: This chart shows the spread between the 10-year and three-year Treasury and gauges investor sentiment. A widening spread suggests investors are optimistic about the state of the economy, whereas a negative spread suggests pessimism. This indicator is less sensitive than the financial spread as it is less affected by the Fed's decisions.

Two-Year Difference in the Unemployment Rate: The two-year difference in the unemployment rate measures the amount of slack in the labor market. When the difference of the two-year unemployment rate falls below zero, it indicates the labor market is becoming less tight.

Weekly Initial Claims: This chart shows the four-week moving average of initial jobless claims. A rising initial claims number means the demand for labor is weakening, likely due to a worsening business environment. If the four-week moving average rises above 350K, it signals the economy August be headed toward a contraction.